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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-684

STEPHENS, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. A-29-A-50) is reported at 321 F. Supp. 1159. The opinion of the court of appeals (Pet. App. A-1-A-27) is reported at 464 F. 2d 53.

JURISDICTION

The judgment of the court of appeals was entered on July 10, 1972. (Pet. App. A-1.) A petition for either a rehearing or a rehearing *en banc* was denied on August 22, 1972. (Pet. App. A-28.) The petition for a writ of

certiorari was filed on November 2, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that petitioner was not a dealer in securities within the meaning of Section 1.471-5 of Treasury Regulations on Income Tax (1954 Code) with respect to the particular stocks in issue.

2. Whether the court of appeals correctly held that the transaction whereby the business of Utilities was transferred to, and continued by, two newly created corporations and the stock of these corporations distributed pro rata to Utilities' stockholders, including petitioner, was a corporate reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 243, 267, 331 and 368 of the Internal Revenue Code of 1954 and Section 1.471-5 of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 11-15.

STATEMENT

Petitioner, the nineteenth largest investment house in the United States, has its principal place of business in Little Rock, Arkansas. All of its outstanding stock is owned equally by two brothers, W. R. and Jack T. Stephens, who are prominent in financial and business affairs in Arkansas. (Pet. App. A-29-A-30.)

The particular transactions in issue here involved petitioner's acquisition and sale of the stock of five corporations: Stephens Finance Company (formerly El Dorado Water Company), Hollis & Company, Public Utilities Company of Crossett, Arkansas, V. E. Schevenell, Inc., and Tuf-Nut Manufacturing Company (formerly Little Rock Tent & Awning Company). (Pet. App. A-33.) The facts, in each instance, followed a similar pattern. Petitioner, either alone or with other parties, would acquire 100 percent of the stock of the particular corporation and then cause the corporation to declare an extraordinarily large dividend. Subsequently, the entire stock interest would be sold. (Pet. App. A-8-A-17, A-34.) In some instances, petitioner would manage the acquired corporation and revise its capital structure in order to make the corporation more salable. (Pet. App. A-8.)

For tax purposes, petitioner would include the dividend in taxable income and claim a dividend-received deduction equal to 85 percent of the dividend. Section 243 of the Code, Appendix, *infra*, p. 11. Also, claiming to be a dealer in securities with respect to the stock of the acquired corporation and, therefore, entitled to use the inventory method of accounting, petitioner would "write down" the stock's closing inventory value by the amount of the dividend. See Section 1.471-5 of the Treasury Regulations on Income Tax (1954 Code), Appendix, *infra*, pp. 14-15. This inventory reduction increased petitioner's reported cost of goods sold during the taxable period, thereby resulting in a reduction in taxable income. Subsequently, when the stock was resold for a price approximately equal to petitioner's

original cost minus the dividend, petitioner would not claim a tax loss because it treated the inventory write-down as reducing its basis in the stock.[1] (Pet. App. A-2-A-3, A-8-A-18, A-34.)

Upon audit, the Commissioner ruled that petitioner was not a dealer in securities with respect to the stock of the five corporations in issue here and, therefore, not entitled to use the inventory method of accounting. He disallowed the deductions for the claimed inventory write-downs and determined deficiencies accordingly. The district court decided this issue for the Government with respect to the Stephens Finance Company stock and for petitioner with respect to the stock of the other four corporations. (Pet. App. A-39, A-51-A-52.) Upon cross-appeals, the court of appeals decided this issue for the government with respect to the stock of all five corporations except Hollis & Company,[2] thereby affirming in part and reversing in part the judgment of the district court. (Pet. App. A-7-A-17.)

Having held for the government with respect to the Public Utilities Company of Crossett, Arkansas (Utili-

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[1] With respect to one of the companies (Schevenell), petitioner sold the shares in the year of purchase, and, consequently, did not attempt to write down the inventory value of these shares. Instead, treating them as inventory, it claimed an ordinary loss, roughly in the amount of the dividend. The government, denying inventory treatment, asserted that the loss was a short-term capital loss. The court of appeals agreed. (Pet. App. A-8-A-9.)

[2] The court of appeals held that the issue of petitioner's status as a dealer in securities with respect to the Hollis & Company stock was not justiciable, and therefore it did not decide the issue. Any refund for the year in which write-down of the Hollis & Company stock was claimed is barred by the statute of limitations, and petitioner made no showing that resolution of the issue would affect its tax liability for the years in litigation. (Pet. App. A-7.)

ties) stock, the court of appeals was then required to decide an additional issue arising out of the disposition of that stock. Petitioner and two other corporations acquired the Utilities stock in petitioner's fiscal year ended May 31, 1963. A large dividend was paid in that year and an inventory write-down claimed as of May 31, 1963, because of the dividend. In November, 1963, a plan of liquidation and dissolution was adopted and executed whereby (1) Utilities was dissolved, and (2) its assets, subject to liabilities, were transferred to two newly created corporations in exchange for their stock, which was distributed pro rata to petitioner and the other shareholders of Utilities. In late December, 1963, petitioner sold these shares to its shareholders, W. R. and Jack T. Stephens. (Pet. App. A-14-A-15, A-18-A-19).

Petitioner treated the liquidation of Utilities in November, 1963, as a taxable event (see Section 331 of the Code, Appendix, *infra,* pp. 12-13) and, assuming that its basis in its Utilities stock was reduced by the claimed inventory reduction in fiscal year 1963, reported a taxable gain in fiscal year 1964. If, as the court of appeals held, petitioner's inventory write-down is disallowed in fiscal year 1963, it follows that petitioner's original cost basis must be used in determining petitioner's tax liability in fiscal year 1964. And, if the liquidation of Utilities were taxable, using petitioner's original cost basis would result in a loss rather than a gain. However, it is the Government's position that the liquidation was part of a corporate reorganization within the meaning of Section 368(a)(1)(D) of the Code, Appendix, *infra,* p. 13. It follows that petitioner's cost basis in its Utilities stock carried

over to the stock of the two newly created corporations and, pursuant to Section 267 of the Code, Appendix, *infra*, pp. 11-12, no loss could be recognized upon the sale of this stock to petitioner's shareholders, W. R. and Jack T. Stephens.

The district court held that there was a corporate reorganization and the court of appeals affirmed. (Pet. App. A-26, A-52.)

ARGUMENT

The decision of the court of appeals is correct. There is no conflict of decisions or any other reason for further review by this Court.

1. Citing *Commissioner* v. *Duberstein*, 363 U.S. 278, petitioner contends (Pet. 8-10) that the court of appeals exceeded its proper authority in reversing the decision of the district court with respect to petitioner's status as a dealer in securities. This contention is premised upon the mischaracterization of the decision of the court of appeals as a redetermination of a factual finding by the district court. The court of appeals made no such factual redetermination.

Section 1.471-5 of the Treasury Regulations on Income Tax (1954 Code), Appendix, *infra*, pp. 14-15, defines a dealer in securities as—

> a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom.

The district court held that petitioner was a dealer in securities in the stocks in issue within the meaning of

the regulation simply because petitioner purchased the stocks (Pet. App. A-39) "for the purpose of reselling them and not for the purpose of holding them for investment or speculative purposes." Petitioner now claims that, in reversing the district court, the court of appeals "sharply disagreed" with this finding. (Pet. 9.)

This was not the case at all. Upon appeal, the government explicitly accepted the district court's finding that petitioner purchased the stocks in issue for the purpose of reselling them and not for investment or speculation. The question presented to the court of appeals was whether that fact alone was sufficient to make petitioner a dealer in those stocks within the meaning of the regulation. (Brief for the United States, p. 23.) The court of appeals decided this question for the government, holding that (Pet. App. A-17) "the ultimate resale motive which is the basis of the trial court's holding is insufficient to support the court's determination that taxpayer is a 'dealer in securities.'" Pointing out that petitioner planned to derive its profit from the large dividend distributions as well as from the resale of the stocks, the court of appeals held (Pet. App. A-11) that a "dealer's profit must accrue strictly from the sale of the security itself and cannot be planned to arise from the necessity of combining the investment income yielded by the security and the ultimate resale price." In this respect, the court explicitly disagreed with the district court, which had construed the regulation as not requiring that the dealer's anticipated profit be derived solely from the resale of the stocks. (Pet. App. A-5-A-6, A-39-A-40.) Similarly, the court of appeals disagreed with the district court's construction of the regulation by holding that peti-

tioner's management and restructuring of the acquired corporations was inconsistent with its claimed dealer status. (Pet. App. A-17, A-40.) Finally, the court of appeals pointed out that petitioner did not hold the stocks for resale to its customers as is required by the regulation, but, instead, attempted to sell all of the stock of a particular corporation to a single purchaser. (Pet. App. A-7-A-8.) Thus the court of appeals did not simply redetermine a factual finding made by the district court as petitioner claims. The court of appeals disagreed with the district court's construction of the governing Treasury regulation and reversed for that reason. The court of appeals' construction of the regulation is amply supported by the relevant authority. See, e.g., *Helvering* v. *Fried*, 299 U.S. 175, and *Brown* v. *United States*, 426 F. 2d 355 (Ct. Cl.).

2. There is also no merit to petitioner's contention that the transaction whereby the business of Utilities was transferred to, and continued by, two newly created corporations was not a corporate reorganization within the meaning of Section 368(a)(1)(D), Appendix, *infra*, p. 13. Petitioner contends that it lacked the requisite control of the new corporations because it sold their stock a month later. It claims that this "momentary control" was not sufficient and alleges a conflict with the Second and Ninth Circuits. (Pet. 10-14.)

Section 368(a)(1)(D) requires that the transferor corporation or its shareholders be in control of the transferee corporation "immediately after the transfer." There is no requirement with respect to how long that control must be maintained. The question is not how long petitioner held the stock of the new corporations, but whether petitioner was obligated by a pre-

existing plan or contract to divest itself of the stock. (Pet. App. A-23.) If petitioner were so obligated, it did not possess sufficient rights of ownership to constitute control. *Heberlein Patent Corp.* v. *Commissioner*, 105 F. 2d 965 (C.A. 2); *Commissioner* v. *Schumacher Wall Bd. Corp.*, 93 F. 2d 79 (C.A. 9); *Hazeltine Corp.* v. *Commissioner*, 89 F. 2d 513 (C.A. 3). If, on the other hand, petitioner were not so obligated, the subsequent sale of the stock, even if originally intended, has no effect on the determination that taxpayer possessed unfettered control of the new corporations immediately after the transfer. *Wilgard Realty Co.* v. *Commissioner*, 127 F. 2d 514 (C.A. 2), certiorari denied, 317 U.S. 655;[3] *C. T. Inv. Co.* v. *Commissioner*, 88 F. 2d 582 (C.A. 8); *American Bantam Car Co.* v. *Commissioner*, 11 T.C. 397, affirmed *per curiam*, 177 F. 2d 513 (C.A. 3), certiorari denied, 339 U.S. 920.

In the instant case, petitioner was not obligated to sell its stock to its shareholders, the Stephens brothers; nor was that sale part of the plan of reorganization of Utilities. (Pet. App. A-22-A-26.) Therefore, the hold-

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[3] As pointed out by the court of appeals (Pet. App. A-23, fn. 13), *Wilgard Realty Co.* presented the question whether the requisite control existed to create a tax-free incorporation rather than a corporate reorganization. But, since the statutory requirement is the same (i.e., the transferors of property to the corporation must be in control of the transferee corporation immediately after the exchange of the property for the corporation's stock and securities (Section 351 of the Code)), *Wilgard Realty Co.* is directly applicable here. In *Wilgard Realty Co.*, the court held that the requisite control existed immediately after the exchange even though the transferor made gifts of approximately three-fourths of the corporation's stock on the same day. The dispositive fact was that the transferor was not obligated to make this gift or otherwise transfer the stock. The making of the gift did not alter this fact.

ing of the court of appeals that petitioner acquired the requisite, unfettered control of the new corporations is supported by the cases cited above. And, since these cases include decisions of the Second and Ninth Circuits, there is no conflict of decisions as petitioner contends. The issues presented in *Commissioner* v. *Berghash*, 361 F. 2d 257 (C.A. 2), and *Breech* v. *United States*, 439 F. 2d 409 (C.A. 9), cited by petitioner (Pet. 13), are far different from the issue presented here.[4] In those cases, the transferors never achieved the 80 percent ownership requisite for control, fettered or otherwise.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER, 1972.

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[4] *Mailloux* v. *Commissioner*, 320 F. 2d 60 (C.A. 5), cited by petitioner (Pet. 12), is also not in point. Contrary to petitioner's description of *Mailloux* (Pet. 12, fn. 12), the taxpayer in that case was not the party who transferred property to the new corporation in exchange for 900,000 shares of stock. Indeed, the issue in the case was whether the taxpayer, another individual, did receive his stock in exchange for property rather than services. It was necessary that the exchange be for property if the exchange were to be tax-free under Section 351 of the Code. Control of the new corporation immediately after the exchange was not in issue.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 243 [as amended by Sec. 214(a), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19]. DIVIDENDS RECEIVED BY CORPORATIONS.

(a) *General Rule.*—In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 85 percent, in the case of dividends other than dividends described in paragraph (2) or (3);

(2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958; and

(3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

* * * * *

SEC. 267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS.

(a) *Deductions Disallowed.*—No deduction shall be allowed—

(1) *Losses.*—In respect of losses from sales or exchanges of property (other than losses in cases

of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of subsection (b).

* * * * *

(b) *Relationships.*—The persons referred to in subsection (a) are:

* * * * *

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

* * * * *

(c) *Constructive Ownership of Stock.*—* * *

* * * * *

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

* * * * *

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

* * * * *

SEC. 331. GAIN OR LOSS TO SHAREHOLDERS IN CORPORATE LIQUIDATIONS.

(a) *General Rule.*—

(1) *Complete liquidations.*—Amounts distrib-

uted in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

* * * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*—

(1) *In general.*—For purposes of parts I and II and this part, the term "reorganization" means—

* * * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

* * * * *

(c) *Control.*—For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at

least 80 percent of the total number of shares of all other classes of stock of the corporation.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.471-5 *Inventories by dealers in securities.*

A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept, provided that a description of the method employed is included in or attached to the return, that all the securities are inventoried by the same method, and that such method is adhered to in subsequent years, unless another method is authorized by the Commissioner pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446-1. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities

and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as provided in this section may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section.

☆ U. S. Government Printing Office: 1972—490—526/370